

**DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 06-0319
INCOME TAX
FOR TAX PERIOD 2002-2003**

NOTICE: Under IC § 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. Adjusted Gross Income Tax – Bad Debt Deduction

Authority: IC § 6-3-2-1(b); IC § 6-3-1-3.5; 26 U.S.C.A. § 166; 26 C.F.R. § 1.166-1.

The taxpayers protest the disallowance of the bad debt deduction.

II. Adjusted Gross Income Tax – Cost of Goods Sold

Authority: IC § 6-8.1-5-1(b); IC 6-8.1-5-4(a).

The taxpayers protest the adjustment to the cost of goods sold.

III. Tax Administration- Ten Percent Negligence Penalty

Authority: IC § 6-8.1-10-2.1; 45 IAC 15-11-2(b)(c).

The taxpayers protest the imposition of the ten percent negligence penalty.

STATEMENT OF FACTS

The taxpayers are a married couple who are equal shareholders in an S corporation. Among other activities, the corporation repaired automobiles and sold used automobiles. After an audit for the tax period 2002-2003, the Indiana Department of Revenue, hereinafter referred to as the "Department," assessed additional adjusted gross income tax, penalty, and interest against the taxpayers. They protested the assessments. A hearing was held and this Letter of Findings results.

I. Adjusted Gross Income Tax – Bad Debt Deduction

Discussion

The taxpayers claimed a bad debt deduction on the corporate adjusted gross income tax return. The Department disallowed the deduction. The disallowance of the corporate bad debt deduction raised the amount of S corporation taxable income passed through to the taxpayers. The disallowance resulted in an assessment of additional adjusted gross income tax. The taxpayers protested the disallowance of the corporate bad debt deduction and resulting assessment of additional tax against them.

Indiana imposes an adjusted gross income tax on the income of corporations. IC § 6-3-2-1(b). To compute a corporation's Indiana adjusted gross income tax, one begins with the federal adjusted gross income and makes certain adjustments. IC § 6-3-1-3.5. A bad debt deduction is not one of the listed adjustments the taxpayer must make to its federal adjusted gross income. Therefore, the federal bad debt deduction found at 26 U.S.C.A. § 166 also applies to a corporation's Indiana adjusted gross income. The bad debt deduction for federal and Indiana purposes is clarified at 26 C.F.R. § 1.166-1 as being available only to corporations conducting business on an accrual accounting method. Since the corporation was a cash basis corporation, it could not take a bad debt deduction. The Department properly denied the bad debt deduction.

Finding

The taxpayers' protest is denied.

II. Adjusted Gross Income Tax – Cost of Goods Sold

Discussion

The Department determined that the corporation reported an incorrect opening inventory amount. There was also an error in the value of inventory carried forward from 2002 to 2003. Therefore, the Department corrected these mistakes. The correction lowered the corporation's cost of goods sold. Deducting the lower value of the corporation's cost of goods sold from the corporation's gross sales resulted in a higher taxable income for the corporation. The resulting additional corporate taxable income was passed through to the taxpayers' individual tax return. This higher pass through resulted in an adjusted gross income tax assessment against the taxpayers. The taxpayers protested this assessment.

Notices of proposed assessments are prima facie evidence that the Department's claim for unpaid taxes is valid. IC § 6-8.1-5-1(b). The taxpayer has the burden of proving that the Department incorrectly imposed the assessment. *Id.* Taxpayers have the duty to maintain books and records of their affairs and present those to the department for review upon the Department's request. IC 6-8.1-5-4(a).

The taxpayers were unable to present any documentation to sustain their burden of proving that the Department's calculation of the corporation's cost of goods sold was incorrect.

Finding

The taxpayer's protest is denied.

III. Tax Administration- Ten Percent Negligence Penalty

Discussion

The taxpayers protest the imposition of the ten percent negligence penalty pursuant to IC § 6-8.1-10-2.1. Indiana Regulation 45 IAC 15-11-2(b) clarifies the standard for the imposition of the negligence penalty as follows:

Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

The standard for waiving the negligence penalty is given at 45 IAC 15-11-2(c) as follows:

The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:

- (1) the nature of the tax involved;
- (2) judicial precedents set by Indiana courts;
- (3) judicial precedents established in jurisdictions outside Indiana;
- (4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc;
- (5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.

Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

The taxpayers did not exercise the standard of care expected of the reasonable business person because the taxpayers failed to keep adequate records and follow instructions issued by the Department on how to properly calculate their adjusted gross income tax. This failure constituted negligence.

Finding

The taxpayers' protest is denied.

KMA/BK/DK – September 20, 2006